# Taxing banks – here we go again!

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# Taxing banks – here we go again!

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*New taxes on banks are likely. The European Commission has proposed a financial transaction tax and a financial activities tax. This column evaluates those proposals and identifies other potential taxation mechanisms the EC has overlooked. It says that the proposed measures are poorly suited to curb excessively risky trading and eliminate undertaxation of the financial sector.*

For many years, taxation of financial institutions was a topic for specialists, both among tax or public finance economists and among financial economists. The current crisis and the need for large-scale recapitalisations of banks have changed this dramatically, and new taxes on banks now form part of the broader debate on regulatory reform. Over the past three years, several proposals to introduce new financial-sector taxation, in some form or another, have emerged in the political arena, and now the time has come to get specific.

On 28 September 2011, the European Commission published a proposal for a new directive on a common system of financial transaction tax, with an EU-wide tax rate of 0.1% on bond and equity transactions, and of 0.01% on derivative transactions between financial firms.[1]

In its impact assessment study, the European Commission juxtaposes a common financial transaction tax (FTT) with a common financial activities tax (FAT). The FAT would tax the combined profits and wages in the financial sector, as an approximation of its value-added.

Below, we will assess both proposals. However, we maintain that, by presenting us with a horse race between an FTT and an FAT, the European Commission is unduly restricting the debate on appropriate new taxation of the financial sector.

An obvious step towards bringing about appropriate taxation of the financial sector is eliminating the current VAT exemption of most financial services. The current undertaxation of the financial sector resulting from the VAT exemption is mentioned by the European Commission as a main reason to introduce additional taxation of the financial sector. However, if the problem is the current VAT exemption, isn't the right solution to eliminate it?[2] Unfortunately, the European Commission is missing the opportunity to bring the financial sector under full VAT created by the current momentum in favour of more taxation on the financial sector. Instead, the European Commission states that the issue of financial-sector VAT should be solved in the context of a Green Paper on VAT reform, with uncertain timing and outcome.

Unfortunately, by framing the policy choice as between an FTT and an FAT, the Commission is also giving short shrift to the need for a common approach to bank levies in Europe. Bank levies are taxes on a bank's liabilities that generally exclude deposits that are covered by deposit insurance schemes.

Bank levies appropriately follow the 'polluter-pays' principle, as they target the banks – and their high leverage – that are heavily implicated in the recent financial crisis. Bank levies have significant potential to raise revenue and they directly discourage bank leverage, thereby reducing the chance of future bank instability. In sophisticated versions of bank levies, they are targeted at risky bank finance such as short-term wholesale finance, and they may be higher for banks with high leverage, or for banks that are systemically important. It is exactly because of these benefits that many individual EU member states are considering or already have in place taxes on bank liabilities.

National, uncoordinated policies regarding bank levies can create competitive distortions in the international banking industry, possibly leading to international bank relocations and international double taxation. Hence, a common EU framework on bank levies would be very helpful, and the failure of the European Commission to publish a proposed directive to coordinate this type of taxation so far is regrettable. In a communication on bank resolution funds published in 2010, the European Commission mentions bank levies as a possible means to finance such funds, but it is unclear whether this thinking will lead to a legislative proposal to coordinate bank levies in the EU.[3] Previously, the IMF (Cotarelli 2010) has come out in favour of either an FAT or bank levies as appropriate ways to impose new taxes on the financial sector, while not favouring an FTT.

## Financial transaction tax

Keynes was one of the first prominent proponents of such a tax. In his *General Theory*, he proposed a securities transactions tax to reduce destabilising speculation in equity markets. Tobin suggested a currency transaction tax to throw sand into the overheated gears of the global financial system and to limit speculation by reducing velocity and volume of transactions (Tobin 1978). More recently, its considerable revenue potentials have also come into view. Many economists – including Nobel Prize winners like Paul Krugman and Joseph Stiglitz – have backed the tax. While many proponents have grown uneasy with its anti-speculation merits, they rather focus on the revenue aspect and emphasise that even a relatively low tax rate on a broad range of financial transactions would raise a large volume of revenue, with little distortion of capital flows. Even advocates of such a tax, however, recognise that implementing such a tax would require significant international coordination since those taxed would seek to escape the tax by moving activity to another country.

As pointed out by many economists, transaction taxes are too crude an instrument to prevent market-distorting speculation. On the contrary, by reducing trading volume they can distort pricing since individual transactions will cause greater price swings and fluctuations. But above all, not every transaction is a market-distorting speculation. Speculation is not easy to identify. For example, which is the market-distorting bet – one against or for a Greek government bankruptcy? Did the losses of the banks in the US subprime sector occur due to speculation or just bad investment decisions? What is the threshold of trading volume or frequency beyond which it is speculators and not participants with legitimate needs that drive the market price for corn, euros, or Greek government bonds?

Most importantly, however, FTTs are not the right instrument to reduce risk taking and fragility in the financial sector, as all transactions are taxed at the same rate, independent of their risk profile. There are arguments that such a transaction tax would hit high-frequency trading hardest (Persaud 2011). But who is to say that this is the riskiest or most speculative trading? Careful analysis by Honohan and Yoder (2011) also shows that an FTT would not have impacted the CDO or CDS market in the run-up to the current crisis. The behavourial goal of taxation would thus certainly not be achieved. The revenue-raising goal, on the other hand, will certainly depend on the tax elasticities of the activities, which might be hard to estimate *ex ante*. Honohan and Yoder (2011) argue that even low tax rates might make certain market segments that rely on transaction-intensive trading technology unsustainable, which undermines the revenue goal.

## Financial activities tax

The European Commission compares an FTT to the alternative of an FAT. This latter tax would apply to the combined profits and wage bill of financial institutions and thus be a broad tax on income generated in the financial sector. This has the advantages that the FAT does not discriminate among various financial-sector activities, and that it is able to generate considerable revenue at low tax rates. The base of the FAT amounts to the financial sector's value-added so that this tax corrects the current undertaxation of the financial sector through the VAT. On the other hand, a straight FAT does not discriminate among financial-sector activities on the basis of their contribution to financial institution risk. However, an FAT that only taxes ‘excess profits’, *ie* profits that go beyond providing equity holders with some reasonable return, could potentially help to curb financial institution risk taking.

A recent paper by Huizinga *et al* (2011) explains how such a tax may affect banks’ behaviour by looking at how banks change pricing behaviour across countries with different tax rates. Huizinga *et al* (2011) find that the burden of the international double taxation of corporate income in the banking sector is almost fully passed on to a bank's lending and depositor customers in the form of a higher bank interest margin. An estimated 86.2% of the additional international tax is reflected in higher bank interest margins abroad, while only 13.8% of this tax appears to be borne by bank shareholders.

The similarity between the FAT and the corporate income tax – they both apply to corporate profits of banks – suggests that the pass-through of an FAT to bank customers would be substantial as well. This makes the FAT a tax on bank customers rather than on bank shareholders. In effect, the FAT would appropriately lead to higher prices of services supplied by banks, reflecting the risks that banks pose to financial stability. In contrast, the incidence of an FTT is far less clear. All the same, an FTT is less likely to lead to higher prices for mainstream bank services and to curb bank risk taking. This makes the FAT preferred to an FTT as a means to increase the contribution of the banking sector to public finances, and as a tool to reduce banking-sector risk taking.

## Evaluation

A disadvantage of the FAT is that it is does not sit well within the overall system of VAT as we know it. The FAT appropriately corrects for the undertaxation of the value-added of banks, but it does not allow for the computation of VAT input credits for businesses that are users of financial services – giving rise to a form of double taxation, as bank valued-added is taxed at the level of the bank and at the level of its business customers. For this reason, it is better to eliminate the current VAT exemption on financial services rather than to introduce a new FAT. Unfortunately, the Commission relegates possible reform of the current VAT treatment of financial services to some undefined point in the future.

As indicated, the current Commission proposal also foregoes the opportunity to bring about a common EU framework for bank levies that is sorely needed.

Thus, in its current proposal the European Commission is bypassing the first-best and second-best solutions to the current undertaxation of the EU banking sector, in the form of financial-sector VAT reform and a common framework for bank levies in the EU. Instead, the Commission is presenting us with a choice between third-best and fourth-best outcomes, *ie* a choice between the FAT and the FTT, and even then the Commission makes the wrong choice of favouring an FTT over a FAT. However, the Commission's current proposal to increase financial-sector taxation is unlikely to be its last one, given the already clear political opposition to an FTT in the United Kingdom among other countries. Hence, there are likely to be opportunities for the Commission to present a revised plan for financial-sector taxation in the future.

Generally, optimal policy requires a combination of financial-sector taxation and regulation. To some extent, taxation and regulation are substitutes, as both can, for instance, be used to effect higher bank capitalisation rates. However, taxation is a better tool to bring about a balance between the private benefits and social costs of bank decisions, for instance regarding their risk taking.

This benefit of taxation over regulation, however, only materialises if there is no *quid pro quo*. Taxes or bank levies should not be interpreted as the purchases of bank liability insurance, which enables banks to take on more asset risk. A bank levy that goes into a failure resolution fund to finance future bank bailouts is the wrong step, since it turns an implicit public guarantee into an explicit one. Today the market still has to take into account a residual risk that the state does not intervene (as in the case of Lehman Brothers or some smaller banks in the US and Europe).[4] To maintain some risk for bank liability holders, new financial-sector taxes should go into the general budget rather than into earmarked resolution funds.[5]

Finally, to reduce the need for costly public bailouts in the future, it is important to improve the operation of bank recovery and resolution mechanisms in Europe. As discussed by Allen *et al* (2011), the current crisis has revealed important deficiencies and gaps in the European bank resolution framework. Much can be gained by moving to a common bank recovery and resolution framework that provides authorities with more options to intervene at fragile banks and to come to speedy and less costly resolutions of banks if needed.

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[1] See http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/com(2011)594_en.pdf.

[2] Huizinga (2002) estimates that bringing financial services under normal VAT would raise around €12.2 billion for the EU15 in 1998, which is equivalent to about 0.15% of GDP.

[3] See http://ec.europa.eu/internal_market/bank/docs/crisis-management/funds/co....

[4] For additional discussion on such a resolution fund, including a procyclical bias, see Allen *et al* (2011).

[5] For a more detailed discussion on this, see Beck and Losse-Müller (2011).



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**Topics**: Financial markets, International finance, Macroeconomic policy
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